

# The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

## Growth investing is not a race

### How to achieve long-horizon equity growth with lower volatility

The kind of growth that adds meaningful value to a portfolio generally does not take place over a few months.

Companies that are capable of sustaining and propelling portfolios for years or decades must be able to sustain their growth trajectory for very long periods of time. And for this to happen, Aziz Hamzaogullari believes they must have unusually persistent competitive advantages.

### Only 1% of businesses can defend their turf

Only very rare and unique businesses can create and sustain a competitive advantage. Empirically, only 1% of businesses are able to sustain competitive advantages, evidenced by durable, profitable long-term growth – beyond a decade.

When a company achieves above-average returns and growth, it attracts competition and capital. Most businesses fail to defend their turf because their business models can be replicated with sufficient time and capital. “We seek those businesses that can sustain, and preferably extend, their competitive advantages over the long term” says Aziz V. Hamzaogullari, chief investment officer of the Growth Equity Strategies team at Loomis, Sayles & Company, an affiliate of Natixis Investment Managers.

### What makes a wide-moat company?

Genuinely high-quality companies are rare beasts. “You are looking for

advantages that don’t change in a day, a quarter, or even a decade,” says Hamzaogullari.

Despite the successful long-term track records of Meta (Facebook) and Alphabet (Google), investors have regularly doubted the durability of the competitive advantages and growth opportunities of these two high-quality companies.

Hamzaogullari believes these companies have key advantages that are hard, perhaps impossible, to replicate and are well worthy of inclusion in a high-quality growth portfolio – at the right price.

First, they are network companies. More than 3.6 billion people use Meta networks, for instance, representing 75% of the world’s internet users. Its reach is unrivalled, attracting approximately 200m businesses worldwide to its platforms. These businesses do so because of the sustained, industry-leading returns per marketing dollar that can be achieved on Meta’s networks, which is difficult to replicate through other advertising channels. “Whether you spend \$2 or \$2 million with Facebook, you can accurately measure your costs against your return,” says Hamzaogullari.

Then there is scale. The necessary capital investment creates a high barrier to entry for potential competitors. For example, Meta spent approximately \$75 billion on R&D and \$50 billion on sales and marketing in the last five years alone.

And even that level of spending would not guarantee the kind of brand recognition that has allowed Google, for instance, to have a near monopoly on



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### Key takeaways:

- Wide-moat companies are rare, only 1% of companies are able to sustain competitive advantages beyond a decade. Durable profitable growth is also rare, only a very small number of companies sustain growth for more than 10 years.
- Capitalizing on insights generated by its Quality-Growth-Valuation investment process, the Growth Equities Strategies (GES) team may now seek to add value by shorting overvalued growth and structurally deficient businesses trading at a premium, in addition to buying high-quality businesses trading at a discount.
- Short positions in the Long/Short Growth Equity strategy generated about half of the portfolio’s annualized alpha - and were a source of meaningful downside protection since inception, more than a decade ago.

search and enter common parlance as a verb.

High-quality, secular growth companies exist in diverse industries. What's important for Hamzaogullari is that a company meets his Quality-Growth-Valuation criteria. Take Boeing: its core narrow body and wide body businesses have extremely high barriers to entry, and its market dominance is challenged only by Airbus. The two companies together control 90% of the market. As Hamzaogullari notes, "if you are an aircraft customer, you have no real alternative to these two." Even with Covid 19-related cancellations, Boeing's backlog equates to almost five years of 2018 peak-level delivery rates.

Visa has a similarly defensible long-term advantage in its large addressable market: it has issued over 3 billion credit and debit cards in partnership with 16,000 card-issuing banks, operates across more than 200 countries where its cards are accepted by 61 million merchants. Even with its enormous scale, Hamzaogullari estimates Visa's share represents only about 18% of the global personal consumer expenditures market, and believes its growth opportunities remain very large.

"These companies are essential to the fabric of commerce," says Hamzaogullari. "Look what happened when Facebook went down for a few hours. A significant number of businesses suffered as a result because they depend meaningfully on Facebook for advertising.

## The patient wait for mispricing

Market participants have a tendency to run for cover at the merest hint of bad news or to crowd into trades due to misplaced optimism. The consequent mispricings create opportunities for active, long-term, valuation-driven investors such as GES. Insisting on a margin of safety relative to its proprietary estimates of intrinsic value, Hamzaogullari buys secular high-growth companies trading at a discount, and shorts those overvalued growth and structurally deficient businesses trading at a premium. With his research completed well in advance, Hamzaogullari patiently "lies in wait" for the market to present these opportunities.

As of 31 December 2022, the strategy's long component was selling at a 49.4%

discount to the Team's estimate of intrinsic value while the short component was selling at a 29.8% premium to intrinsic value.

The catalyst for mispricing is often quarterly returns which miss consensus expectations. "Amazon is a great business, yet every now and then it has what short-term investors view as a bad quarter," says Hamzaogullari. In fact, in the last 16 years, Amazon has missed quarterly numbers some 12-13 times. On no fewer than 11 occasions, such news triggered a stock price decline of 20% or more – even though the structural advantages and long-term growth opportunity for Amazon remained intact.

Often there is a sound strategic reason for disappointing short-term numbers. Capital expenditure is one such reason. When Alphabet, for instance, bought YouTube for \$1.65 billion in 2006, many investors were sceptical. Why pay so much for so little revenue? But Google had correctly understood that video would be a huge component of online advertising.

Today, Facebook is also making a transition to video. Just as when it moved from desktop to mobile, and then shifted from newsfeed to stories. Doubts surfaced about the intensive use of capital to create Instagram's video product, Reels. Hamzaogullari took advantage of stock price weakness to add to his position recently in this high-quality, secular growth company.

Meanwhile, Boeing still trades at a 50%-plus discount to intrinsic value following the pandemic-driven 90% fall in air traffic. "The pandemic created the biggest opportunity and mispricing in this company in decades," notes Hamzaogullari.

"You only get these kinds of arbitrage opportunities when there is a meaningful difference in investors' views about the future of a business." That is, there is no investment opportunity when everyone agrees. Capitalizing on these opportunities requires a disciplined process and a patient temperament. "You must be comfortable when others are not."

Passive investors frequently assert that large cap companies are efficiently priced. However, these examples highlight the fact that inefficiencies can and do occur in even the most well-known, large cap names. Hamzaogullari points out that often the risk-price distortions can be even more

meaningful as a result of a company's prominence and broad ownership.

## Alpha through time arbitrage

Only 20 or so long positions make it into the Loomis Sayles Long/Short Growth Equity portfolio. Once in the portfolio, they tend to stay there. Portfolio turnover of the longs is around 13%, which implies the average holding period is about eight years. Many names have been in the portfolio for more than a decade, including Amazon, which has been there since inception of the long/sort strategy in 2012 and for over 16 years in the GES flagship Large Cap Growth strategy. A similar number of shorts can also populate the portfolio. Short turnover is roughly 24%, implying a four-year average hold.

This is not to say that the team slavishly holds companies for extended periods. Rather, it holds companies until their share price fully reflects their growth potential, resizing both long and short positions to reflect changing reward to risk and margins of safety as stock prices evolve over time.

In January 2015, for example, GES bought Adidas stock. Short-term investors drove down the price due to what GES viewed as temporary headwinds – weakness in their golf business as well as Reebok division – enabling an entry point for Hamzaogullari well below the Team's estimate of Adidas' intrinsic value. He sold it just two years later in December 2016 when the share price had more than doubled and approached intrinsic value. "Despite concerns about some underperforming business lines, we purchased what we saw as a great brand with great distribution," says Hamzaogullari.

## Single alpha engine drives insights into both long and short opportunities

The Loomis Sayles Long/Short Growth Equity strategy was launched – more than a decade ago – to create a vehicle to capture the short alpha insights, which are an organic outcome of the GES investment philosophy and process.

The short component of the strategy performs double duty – providing a hedge as well as generating alpha. In fact, since inception of the strategy in 2012, the shorts have generated about half of the total gross alpha.

The Loomis Sayles GES team employs two types of shorts: structural and opportunistic. Structural shorts comprise businesses which are mirror images of the high-quality champions. That is, they have no moats with little or no differentiation or competitive advantages and secularly declining growth opportunities - and yet, trade at premiums to the Team's estimates of intrinsic value.

Opportunistic shorts are businesses that are likely to exist in the long term, but trade at expectation levels that are improbable. This may be due to the recency bias of investors.

"Many people confuse short-term wins with long-term success," says Hamzaogullari. The working-from-home phenomenon, for example, led to a raft of over-hyped companies and created shorting opportunities – both structural and opportunistic. As the pandemic started to ease, GES identified some 200

companies that were trading on average 40x sales and 100x or more cash flow (if they had cash flow). "A historical view will tell you few companies have ever managed to meet those levels of expectation," Hamzaogullari says.

The short allocation can markedly reduce portfolio volatility while also protecting capital through market turbulence. In Q4 2018, when the S&P 500 declined 13.5%, the Loomis Sayles Long/Short Growth Equity strategy was down 1% gross. And, in Q1 2020, when the pandemic struck, the S&P 500 declined almost 20% while the strategy actually appreciated by 3.2% gross. The strategy navigated the Q1 2022 market decline with a +3.12% gross return. Finally, while the S&P 500 declined 18.11% for calendar year 2022, the strategy was down 1.71% gross.

Diversification of business drivers is a key aspect of managing portfolio risk or volatility. The Team seeks to invest in imperfectly correlated business drivers

– the GES-identified primary long-term growth driver for each company. Hamzaogullari believes business driver diversification fosters an efficient and effective diversification of risk. This is evidenced by historically very low factor risk, if any, as well as an attractive downside risk profile.

## Winners vs losers: it's win-win

Where there is a winner, there are many losers, and the implementation of that philosophy is central to the Growth Equity Strategies team's long-term alpha generation.

As Hamzaogullari notes: "For alpha generation, the pursuit of greater upside potential and managing absolute levels of risk are inextricable goals."

Published in May 2023

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